The Rise of Retail Financial Services in Indonesia

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I. Introduction

With Western economies marking time in the wake of the financial crisis, the eyes of the world have been on Asia as the force driving the global economy. Since last year's earthquake coupled with continuing appreciation of the yen, Japanese companies, both large and small, have been particularly eager to expand their business in Asia, a lifeline they have no alternative but to grasp.

With wages rising fast in China, Japanese manufactures have been already relocating their Chinese manufacturing bases to Southeast Asian countries, such as Indonesia, Vietnam and Thailand, where labor costs are relatively lower. Following in their footsteps have been Japanese financial services companies eager to provide (mainly financial) assistance to these operations. Foreign banks, which used to court high-net-worth individuals in the region from offshore centers such as Singapore, have now taken one step further by forming tie-ups with local financial players in order to better serve the region's emerging middle classes with onshore financial services including not only basic banking services, but auto loans and insurance.

For its part, the rising middle class in the region has already begun to shift its financial assets from savings to investment. For instance, we can see an increasing demand for online trading and mutual fund products chiefly distributed by banks.

This paper takes a closer look at Indonesia, a country that has the largest population in Southeast Asia and enjoyed rapid economic growth as a result of the recent commodities boom and expanding domestic private consumption. In particular, we put a spotlight on the factors affecting the growth of the retail financial services sector in light of the players, products, regulations and legal environment.

II. Overview of Indonesia's economy

1. Macroeconomic structure

Indonesia consists of more than 17,000 islands and is the world's largest Islamic state with a population of 240 million. More than half of them are under the age of 30, and 80% are Moslems. It is also the only G20 member country in Southeast Asia (Figure 1).

Figure 1: Snapshot of Indonesia

Population	Roughly 240 million (fourth-largest population in the world according to 2010 estimates; half under 30 years of age)
Area	Roughly 1,920,000m^2 (roughly five times as large as Japan, with roughly 18,000 islands)
Capital	Jakarta (population of 9.22 million)
Languages/religions	Indonesian/Islam (87%), Christianity (10%), Hinduism, etc.
Main industries	Petroleum, natural gas, textiles, tobacco, mining, chemical fertilizer, agriculture, construction, tourism, etc.
Exchange rate	¥1 = roughly IDR100 (as of 31 March 2011)
Political system	Republic (President Susilo Bambang Yudhoyono, term ends in 2014)
Nominal GDP (FY10)	IDR6,423 trillion (roughly one-tenth that of Japan)
Credit rating	BB+(Positive, S&P) / Ba1(Stable, Moody's) / BB+(Positive, Fitch)

Note: Credit ratings as of 12 March 2010 (S&P), 17 January 2011 (Moody's), and 24 February 2011 (Fitch).
Source: Nomura Institute of Capital Markets Research, based on Statistics Indonesia, JETRO, and the *CIA World Factbook*

In the past, Indonesia has not been without its social issues, with most of its financial assets owned by ethnic Chinese businesses and foreign companies as well as certain sections of Indonesian society with close links to state-owned enterprises shielded by protectionist government policies. However, since the 1997 Asian Financial Crisis, the Indonesian economy has grown at an average rate of about 5% a year (6.1% in 2010). This is attributed to the increased productivity of the privatized corporate sector, growing domestic consumption against a backdrop of the rising incomes of the rural population due in large part to commodities boom, and a surge in foreign direct investment (FDI). Although nominal GDP (IDR6,400 trillion, roughly ¥65 trillion) is dwarfed by that of developed nations, , per capita nominal GDP has finally broken the $3,000 barrier, the middle class benchmark.

The country has also made progress on the political front since the Asian Financial Crisis, and the political situation has been more stable under the Yudhoyono administration. The country's fiscal position also looks healthy given that public debt accounts for less than 30% of GDP. This led rating agencies such as S&P to raise Indonesia's long-term sovereign debt rating to BB+, one notch below investment grade, in April 2011. Bank Indonesia expects that the country will obtain investment grade status sometime this year. If this proves to be true, we will see a significant increase in FDI and portfolio investment flow[1]. Also, the domestic market will be opened up in the years leading up to 2015, during which the ASEAN Free Trade Area

[1] In the first quarter of 2011 Indonesia had a $19.0 billion surplus on its capital account, roughly one third of which consisted of foreign direct investment. Since the Yudhoyono government came to power in 2005, most of the foreign direct investment in Indonesia has been in the natural resources sector as a result of the sector's rising prices. More recently, however, a growing proportion has been in domestic manufacturing, with a particularly sharp increase in foreign direct investment from China.

(AFTA) is due to reduce import tariffs to zero and many foreign firms are expected to foray into the market[2].

One of the greatest challenges facing emerging countries such as Indonesia will probably be the need for more efficient infrastructure[3]. Indonesia's National Development Planning Agency (BAPPENAS) estimates that the country will need a total of $213.3 billion over the next five years if infrastructure investment is to reach 5% of GDP. However, as the public sector alone cannot meet this funding need, the private sector will need to fill in the gaps by raising $74.1 billion. The government plans to facilitate the infrastructure development through public-private partnership (PPPs) scheme[4].

In a country like Indonesia, it will take long and need much money to build enough roads and bridges over the countless islands. While the country's *Land Acquisition Law* has also been a big obstacle to building transport infrastructure[5], the law was supposed to be amended by the end of 2011.

2. Growing middle class and characteristics of individual financial assets

Last year Indonesia's per capita GDP finally reached $3,000, the middle-class income threshold. If we define "middle class" as those with an annual income of $3,000 to 20,000, it is estimated that the number of Indonesia's middle class people will be at least 50 million, the figure being the highest in Southeast Asia (Figure 2). Furthermore, nearly half of the country's working population is currently employed in the primary sector and the income of those working in plantations and mines in areas including Kalimantan and Sulawesi has soared as commodity prices have risen (Figure 3).

Though we find few statistics on details of individual financial assets in Indonesia, a 2008 survey by Bank Indonesia indicated that nearly 80% of an average household's assets were held in the form of illiquid real estate assets and a mere 9% in the form of financial assets. While over 50% of these financial assets consisted of bank deposits, more risky assets such as shares, bonds, and mutual funds accounted for only a small percentage (Figure 4).

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[2] In January 2010 six member states of ASEAN (Indonesia, Brunei, Thailand, Malaysia, Singapore and the Philippines) signed a free trade agreement with China (ASEAN-China Free Trade Agreement or "ACFTA"). In 2015 membership of ACFTA is due to be extended to the remaining four members of ASEAN (Cambodia, Vietnam, Laos and Myanmar).

[3] Indonesia has only 1,000km of highways, and only half of the country is connected to the electricity grid. The government plans to build 20,000km of roads and supply 15,000Mw of electricity by 2014.

[4] As part of its measures to introduce public-private partnerships the Indonesian government set up the Indonesia Infrastructure Guarantee Fund in 2010 to assess PPP projects and provide various guarantees, including minimizing political interference and protecting project assets.

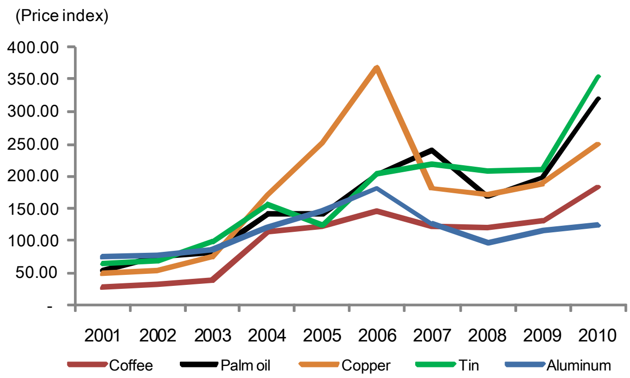
[5] Road and other infrastructure projects currently face other difficulties besides Indonesia's *Land Acquisition Law*. These include corruption. As this poses the risk that the return on a project may not justify the outlay, it remains to be seen to what extent foreign companies will want to be involved in such projects.

Figure 2: Middle-class population

(million persons)		2004	2009	2014 (forecast)
India	cities		26	147.7
	agricultural areas			82.1
China	cities	43.9	307.9	504.9
	agricultural areas		0.4	108.8
Indonesia		**1.6**	**50.4**	**149.7**
Thailand		21	32.9	39.9
Malaysia		14.7	21.3	27
Philippines		3	20.3	47.7
Singapore		3.7	3.9	4.3
Vietnam			1.8	28.4

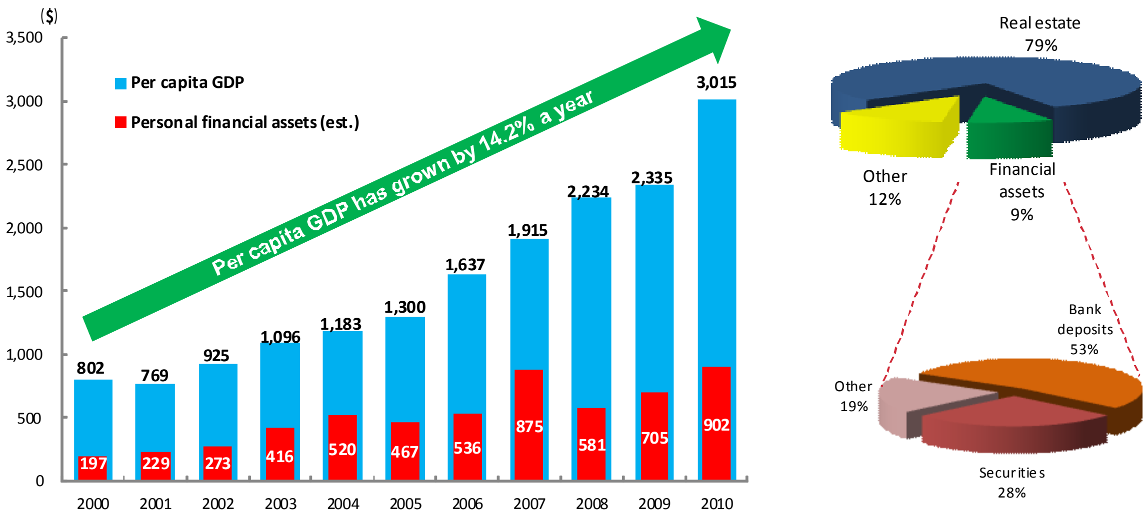
Source: Nomura Institute of Capital Markets Research, based on country household surveys, CEIC, World Bank, and Nomura Global Economics

Figure 3: Commodity prices



Note: Index rebased to 2000 = 100.
Source: Nomura Institute of Capital Markets Research, based on Bank Indonesia data

Figure 4: Per capita GDP and breakdown of household financial assets



Source: Nomura Institute of Capital Markets Research, based on Bank Indonesia and *Indonesian Household Balance Sheet Survey 2008*

However, local market experts suggest that there is a clear trend that Indonesians may have begun to move some of their money out of bank deposits into investment over the past five years of declining interest rates. Additionally, given the fact that financial assets account for less than 10% of individual financial assets, it is safe to argue that all financial providers should have plenty of scope to significantly grow their business.

III. Indonesia's retail financial markets

1. Banking sector

1) Market structure

Indonesia's financial system is dominated by its local banks (Figure 5).The two biggest groups of players, commercial and rural banks account for nearly 80% of the country's financial assets (roughly $360 billion), a picture largely unchanged for the past five years. Even the 10 largest banks in terms of total assets control 65% of these assets. With more than 120 banks operating in the country as of the end of 2010, the banking sector seems to be highly concentrated with few big players at the top and many minor players at the bottom (Figure 6).

Figure 5: Percentage of Indonesia's financial assets owned by each type of financial institution

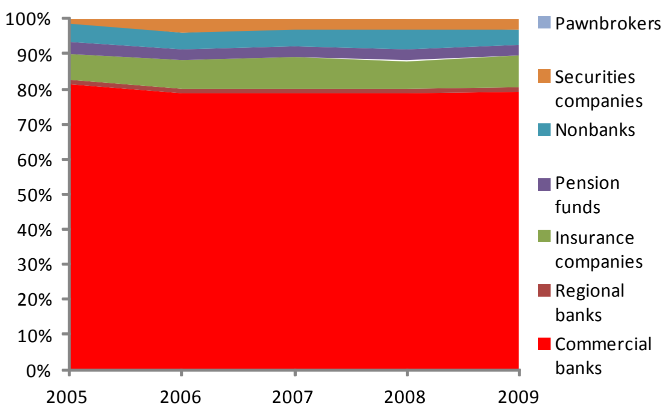


Figure 6: Top 10 Indonesian banks

	Bank	Total assets (IDRtrn)	Share
1	Bank Mandiri*	411	13.65%
2	BRI*	395	13.14%
3	Bank Central Asia	323	10.75%
4	BNI*	241	8.02%
5	Bank CIMB Niaga	143	4.75%
6	Bank Danamon Indonesia	114	3.78%
7	Pan Indonesia Bank	107	3.54%
8	Bank Permata	74	2.46%
9	BII	72	2.39%
10	BTN*	68	2.27%
*State-owned banks	Total	1,948	65%

Source: Nomura Institute of Capital Markets Research, based on Bank Indonesia data and Indonesian Banking Statistics

The total assets of the commercial banks have grown by 15.4% a year since 2005, while 10 players have dropped out of the field (Figure 7). During the same period, outstanding loans have increased by 21% per year, totaling IDR1,766 trillion (roughly ¥18 trillion) that accounts for only 36.5% of GDP at the end of 2010 (Figure 8). Given the relatively small percentage of banking penetration in Indonesia, we could argue that there would be significant room for the banking sector to grow over the years to come[6]. In particular, it has been consumer loans that have enjoyed the highest growth during the past three years.

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6 The ratio of credit to GDP for other emerging Asian economies is China (148%), India (71%), Malaysia (132%), the Philippines (49%), Thailand (136%), and Vietnam (136%).

Figure 7: Total assets and number of commercial banks

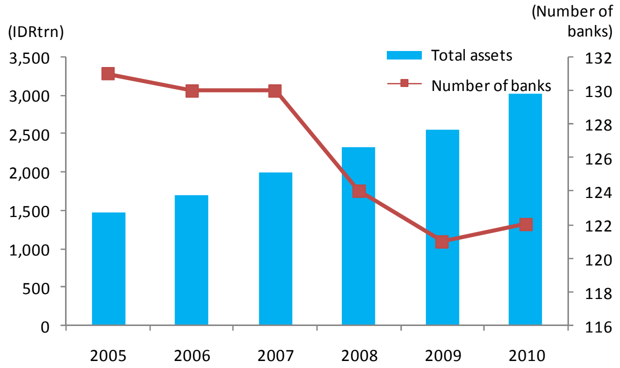
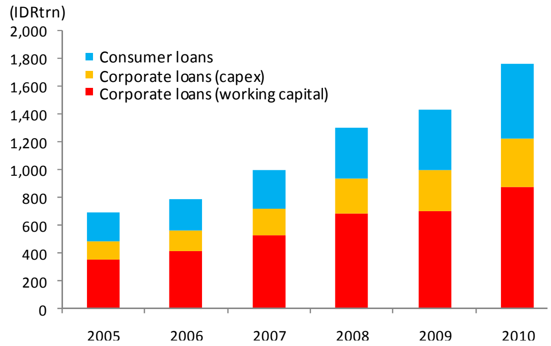


Figure 8: Loans outstanding



Source: Nomura Institute of Capital Markets Research, based on STATISTIK PERBANKAN INDONESIA

2) Key players

There has been little change in the line-up of the top five banks in terms of total assets during the past five years (Figure 9). In 2008 Bank Niaga was acquired by the Malaysian financial conglomerate, CIMB group, and joined the top five banks, replacing Bank Danamon Indonesia in fifth place. Since then Bank Niaga has changed its name to CIMB Niaga and gradually increased its presence. As to Western banks[7], Citibank was in the top 10 between 2005 and 2008 but dropped out of the rankings in 2009[8].

Except for CIMB Niaga, the top 10 banks are mostly local players. The following are brief profiles of the top four players, two of which are state-owned and two privately owned.

Bank Mandiri (state-owned)

Indonesia's largest bank in terms of assets is Bank Mandiri, with total assets of roughly ¥4 trillion (and a market capitalization of roughly ¥1.6 trillion). Established in 1998–99 as part of the government's program to reform the banking sector, it has since absorbed four state-owned banks[9]. The mergers were followed by extensive restructuring (involving integration of technology platforms, headcount reductions, and the closure of redundant offices both at home and abroad). In 2003, the bank was

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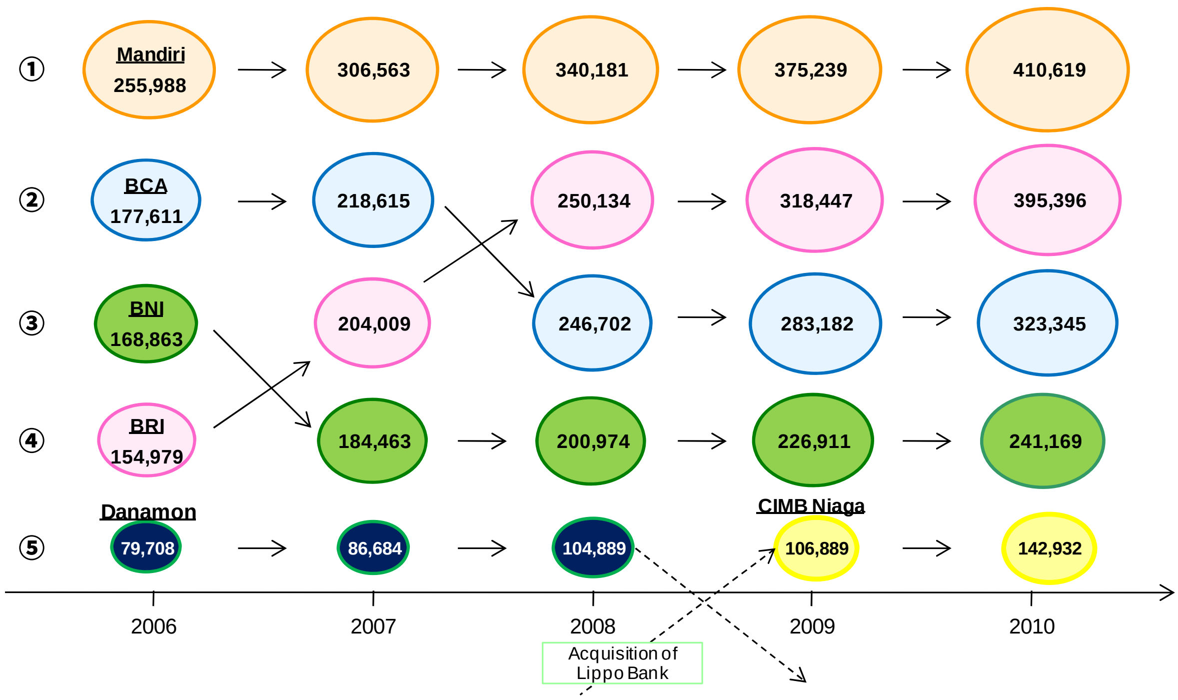
7 Japanese banks' activities in Indonesia have included offering credit guarantees in partnership with local banks as a means of making it easier for Japanese companies to borrow in local currency. Another example is Mizuho Bank's decision to offer onshore financial services in order to meet the needs of the Indonesian middle class.

8 In April 2011 Citibank's Citigold private banking service was rocked by a scandal involving a bank employee skimming the accounts of her priority customers (http://www.thejakartaglobe.com/home/bank-indonesia-tells-citibank-to-stop-issuing-credit-cards/434206).

9 The four banks were BBD, BDN, Exim and Bapindo.

Figure 9: Top five commercial banks



Note: Units: IDR billion.
Source: Nomura Institute of Capital Markets Research, based on STATISTIK PERBANKAN INDONESIA

relisted on the Indonesian stock exchange. The Indonesian government currently has a 60% stake in the bank.

Though Bank Mandiri is still focused on wholesale banking because of its traditional role as a state-owned development bank supporting Indonesia's economic development, it has gradually turned its attention to expand retail banking, including microfinance. The bank's extensive network has enabled its transaction banking revenue from credit cards and remittances to grow to the point (¥50 billion) where it now accounts for about a third of total revenue.

The bank also provides financial services such as stockbroking, mutual funds and insurance through its subsidiaries Mandiri Sekuritas, Mandiri Asset Management, and AXA Mandiri Financial Services, a joint venture with AXA.

BRI (state-owned)

Like Bank Mandiri, Bank Rakyat Indonesia (BRI), the second-largest bank in terms of assets, is a state-owned bank. BRI's forte is microfinance in rural areas. Its outstanding loans have grown more than those of any of the other top five banks during the past five years. While Bank Mandiri counts a large number of major companies among its customers, BRI is focused mainly on small businesses/microenterprises and individuals in the rural areas. In recent years BRI has set up a large number of booths (called "BRI Teras") in urban areas such as Jakarta in order to interest more customers in its microfinance. It is therefore probably fair to say that BRI's marketing strategy has been to improve its corporate image by focusing on microfinance.

BCA

The third-largest bank in terms of assets after Bank Mandiri and BRI is Bank Central Asia (BCA). It has the lowest nonperforming loan ratio of any of the top five banks (0.6%) and the largest market capitalization of any private-sector bank (¥1.6 trillion). In February 2011 it overtook Telekomunikasi Indonesia as the second-largest stock on the Indonesia Stock Exchange in terms of market capitalization. BCA used to be owned by the Salim Group, a large ethnic Chinese conglomerate, but was put under control of the Indonesian Bank Restructuring Agency (IBRA) and nationalized in 1998 after going through bankruptcy during the Asian Financial Crisis. After BCA went public in 2000, IBRA gradually shed its shareholding, divesting 51% in 2002 to a joint venture between a US hedge fund and Indonesia's Hartono family. It has achieved a dramatic turnaround, becoming involved in Islamic finance, general insurance, stockbroking. Last year BCA also entered the motorcycle loan business, a promising field that is expected to expand rapidly in Indonesia.

BCA's main customers are microenterprises selling commodities such as rice and sugar, and run by Indonesians of Chinese origin. BCA seeks to differentiate itself as a transaction bank and current/savings (CASA) accounts constitute a larger proportion (more than 75%) of its deposits than those of any other bank, its cost of credit (2.5%) is much lower than that of other banks[10]. Although 60% of its funding currently comes from ethnic Chinese customers, we expect BCA to target its high-margin motor cycle loans at new, non-Chinese customers and to try to achieve synergies with its general insurance business.

BCA's loans to the wholesale segment as a proportion of its total lending have declined for the past three years and now account for about only one third. Meanwhile, lending to retail customers and small businesses/microenterprises has increased[11]. For example, housing and auto loans have grown by 42% and 34% a year, respectively, for the past three years. As a result, overall consumer loans grew by 36% last year to IDR38.7 trillion (roughly ¥400 billion).

CIMB Niaga

Malaysia's sovereign wealth fund, Khazanah Nasional, used to own the two Indonesian banks Lippo Bank and Niaga Bank. However, in 2008 the two banks had

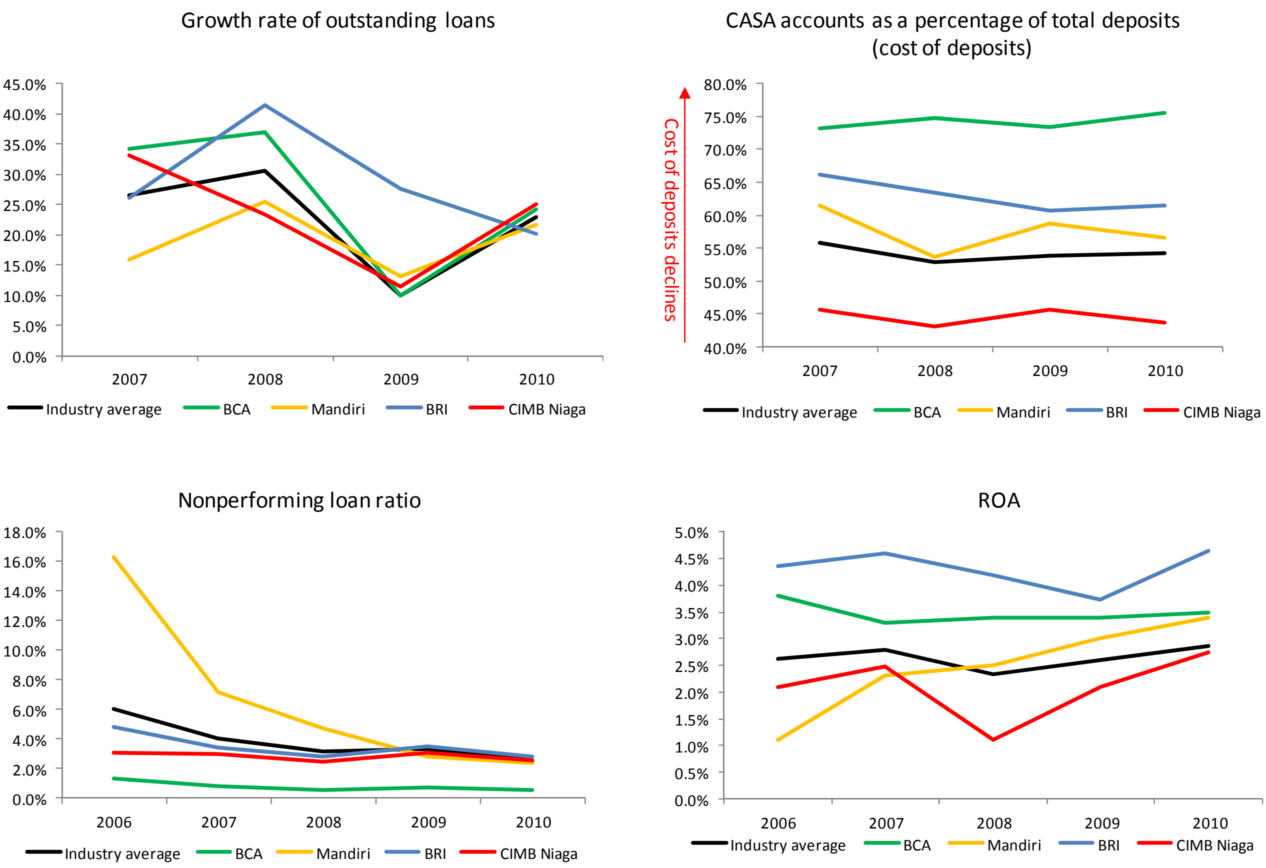
[10] Indonesia is a cash society. As people are not in the habit of making out checks, transaction banking is in great demand. As transaction volume has increased as the economy has grown, BCA has been a beneficiary and currently has a 32–35% share of the market for transaction banking.

[11] The demand for wholesale loans from plantations and farms has increased. However, BCA's share of the market has declined as telecom companies, one of its main groups of customers, have started to make increasing use of Indonesia's capital markets.

to merge in order to comply with the new regulation called "single presence policy". CIMB Niaga was the result[12]. In terms of assets it is the second-largest private-sector Indonesian bank after BCA and has a market capitalization of roughly ¥450 billion. As a leading ASEAN financial group, CIMB has retail banking operations in Cambodia, Thailand and Singapore as well as Malaysia and Indonesia. CIMB Niaga is the flagship of the group’s retail banking business in the region and leads the Islamic finance market in Indonesia.

Figure 10 compares these four banks in terms of profitability (ROA), asset quality (nonperforming loan ratio), funding stability (CASA accounts as a percentage of total deposits), and growth (growth of outstanding loans).

Figure 10: Financial analysis of top four banks



Source: Nomura Institute of Capital Markets Research, based on annual reports of banks concerned

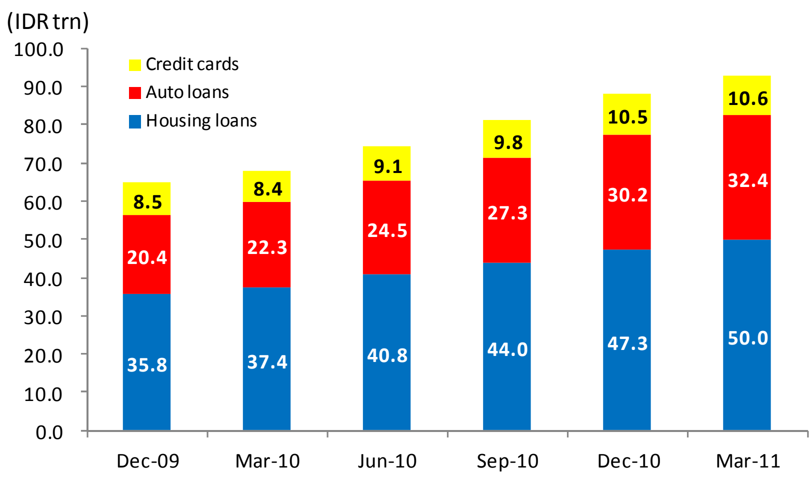
12 Although the number of banks in Indonesia halved as a result of the Asian Currency Crisis of 1997–98, there are still more than 120. Bank Indonesia introduced its "single presence policy" in 2006 in order to streamline the country's banking industry. For further details see 4) Related rules and regulations.

3) Growth of retail banking

The banking penetration in Indonesia remains still low – only 40% of Indonesians are estimated to have a bank account. Accordingly, there exists considerable room for the retail banking business to expand in consumer finance space including housing loans, auto loans, and credit cards as the financial wealth of the country's emerging middle class builds up[13]. With private sector consumption growing and interest rates declining, consumer loans as well as non-interest revenues generated from transaction banking have increasingly gained strategic importance for banks (Figure 11). We estimate the market size of retail banking to have reached ¥3 trillion as of the end of March 2011 considering the share of top three banks in the overall loan market.

Indonesia's ethnic Chinese group, despite its population accounting for less than 5%, is said to dominate the nation's wealth. Furthermore, at least half of Indonesia's high-net-worth individuals have their financial assets managed in offshore centers such as Singapore. However, local market participants indicate that a growing number of wealthy Indonesians may be repatriating their assets as the country's political situation stabilizes. In addition to foreign private banks such as Julius Bär, UBS and Credit Suisse, local players such as Bank Mandiri have entered the private banking space during the past five years[14]. For instance, Bank Mandiri offers a packaged banking service called "Mandiri Priority Service" that caters for the various needs of

Figure 11: Growth of retail banking



Source: Nomura Institute of Capital Markets Research, based on presentations by analysts from Bank Mandiri, BCA, and CIMB Niaga

13 According to interviews with those involved, the ratio of housing loans outstanding to GDP is about 2–3%. Like other consumer loans, housing loans in Indonesia normally charge a variable rather than a fixed rate of interest.

14 In Indonesia's balance of payments statistics, net other investment, an indicator of private capital flows, turned positive (indicating net inflows) in the second half of 2010. This suggests to us that Indonesians have been repatriating their overseas investments as trust in the rupiah has increased and overseas interest rates have declined.

wealthy customers: foreign currency deposits, mutual funds, *bancassurance*, and investment advisory.

We believe that the success of retail banking in Indonesia will hinge on whether the banks can maintain the quality of the loan assets they have rapidly accumulated over the past years. To this end, banks should increase their investment in hardware and software to put more capable risk management and operational efficiency in place.

4) Related laws and regulations

Indonesia's regulation of foreign ownership of domestic commercial banks looks not so stringent as compared to that of neighboring countries. In Indonesia, foreigners are allowed to own up to 99% of the domestic commercial banks. This is in stark contrast to emerging markets such as China and Malaysia, for example, where the foreign ownership is limited to 20% and 30%, respectively[15]. However, according to the local media, the upper limit on foreign ownership may be reduced to 50% in the near future, which could have significant impact on foreign players including Singapore's Temasek Holdings and Malaysia's Maybank, both of which have large stakes in Indonesian banks[16]. Since the Asian Financial Crisis, the Indonesian authorities have shown relatively permissive attitudes to foreign investment in Indonesian banks because foreign players can instill their better risk management practices and more efficient operations. More recently, however, there has been a heated debate about limiting foreign ownership in light of the national interest.

Foreign banks are allowed to open branches in Indonesia without having to forge a tie-up with a local partner, provided their application for a license is successful. However, they need to have paid-up capital of at least IDR3 trillion and be one of the world's 200 largest banks in terms of their total assets. Furthermore, banks are allowed to invest up to only 25% of their consolidated paid-up capital in a nonbank. Bank Indonesia requires commercial banks to have a minimum core capital of IDR100 billion. Otherwise, they are prohibited from providing services such as clearing and payment, and are only allowed to operate in a limited geographical area.

In 2006 Bank Indonesia promulgated the “single presence policy” to restructure the overcrowded banking sector. This policy limits the ability of any bank shareholder, be it the government, Indonesian investors or foreign investors, that owns 25% or more of the shares in each of two or more Indonesian banks or has de facto control of them (even if it owns fewer than 25% of the shares) to control those banks. However, in March 2011 Bank Indonesia decided to postpone implementation of the new policy for two years and also suggested that the policy might not be fully applicable to state-owned banks. (A final decision has yet to be reached.)

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[15] The same percentage applies to shareholdings in securities companies.
[16] Temasek Holdings and Maybank own Bank Danamon and BII, respectively.

2. Capital markets

1) Market structure

While Indonesia's financial system is still dominated by its banking sector, its capital markets have also grown rapidly in recent years. In July 2011, the IDX Composite Index (the benchmark of the Indonesia Stock Exchange, which was formed in November 2007 by the merger of the Jakarta Stock Exchange and the Surabaya Stock Exchange) hit an all-time high of 4,000 points. Indonesia Stock Exchange (IDX) has been one of the best-performing Asian stock markets.

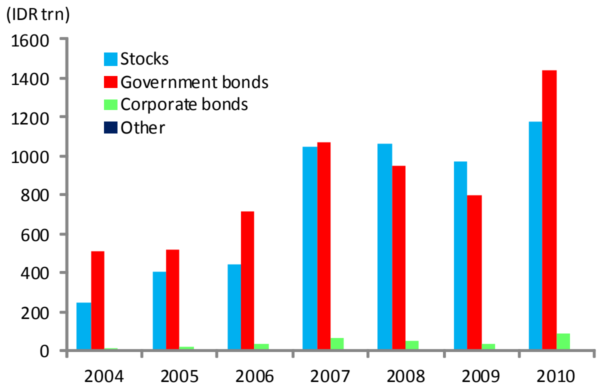
However, there are only about 420 companies listed on the IDX, and the top 50 companies by market capitalization account for approximately 75% of the exchange's annual trading value of IDR1,000 trillion (roughly ¥10 trillion). There are only 30 blue chips that are actively traded. (Figure 12).

The stock market is thus highly concentrated, though the liquidity has been improving due mainly to an increase in foreign investment inflow. According to local securities companies, the average free float – the proportion of outstanding shares in the hands of general public investors – is thought to be only 20%, reflecting a characteristic of the Indonesian stock market, namely that many companies are family-owned[17]. Indonesia's market capitalization of IDR 3,200 trillion (roughly JPY 30 trillion) accounts for less than half of GDP, which will be dwarfed by those of ASEAN nations: 130% for Malaysia, 52% for Thailand, and 50% for the Philippines.

There could be other reasons for low liquidity of the Indonesian stock market. Firstly, the institutional investors basically follow the "buy and hold" strategy. In addition, there are only 100,000 to 200,000 individual investors who actively trade their shares. The dominance of foreign institutional investors, which accounts for

Figure 12: Stock market concentration and securities trading value

	Company	Market capitalization (IDRtrn)	Share (%)
1	Astra International [S]	221	6.8%
2	Telekomunikasi Indonesia. [S]	160	4.9%
3	Bank Central Asia	156	4.8%
4	Bank Mandiri (Persero)	135	4.2%
5	Bank Rakyat Indonesia	128	4.0%
6	Unilever Indonesia [S]	126	3.9%
7	HM Sampoerna	123	3.8%
8	Perusahaan Gas Negara	107	3.3%
9	Adaro Energy	82	2.5%
10	United Tractors [S]	79	2.4%
		Total for top 10 stocks in terms of market capitalization	40.6%



Note: "[S]" denotes Shariah-compliant stocks. "Other" includes warrants, exchange-traded funds, and stock acquisition rights.
Source: Nomura Institute of Capital Markets Research, based on IDX STATISTICS 2010

[17] Interviews with those involved indicate that Bapepam-LK may raise its minimum float requirement for IPOs to 20% from the current level of 10%. In addition, the government offers tax incentives to companies with a float of more than 40% in order to improve liquidity.

more than two-thirds in terms of market capitalization could be a factor for the high volatility of the stock market[18] (Figure 13).

In the 1990s, only a relatively small number of high-net-worth individuals played the stock market. Nowadays a growing number of ordinary people such as even housewives and university students can invest in securities. However, the vast majority of Indonesians currently get access to the capital markets through indirect investment (e.g., pension funds that form the JAMSOSTEK public pension scheme, mutual funds, etc)[19]. At the initiative of the stock exchange and with the cooperation of the Association of Indonesian Securities Companies (APEI) and the Indonesia Capital Market Supervisory Agency (Bapepam-LK), Indonesian securities companies have organized free investment programs and seminars for university students and other young people in order to develop a larger retail investor base.

As far as Indonesia's bond market is concerned, the trading volume of government bonds is comparable to that on the stock market. However, corporate bonds that are primarily issued by state-owned enterprises and banks and asset-backed securities are so thinly traded that liquidity is poor because most of these securities are held until maturity[20]. About 85% of the IDR756 trillion (roughly ¥7.6 trillion) of Indonesian bonds outstanding are government bonds. Notably, foreign investors are gradually increasing their share of these bonds while Indonesian banks, who used to be a dominant player in this space, have shed their bond holdings. This is a clear trend that we expect to continue following the upgrade of Indonesia's sovereign debt in April 2011 and a further decline in interest rates (leaving 10-year government bonds trading at a yield of roughly 7.4%).

Figure 13: Investor participation

		2007	2008	2009
Stock market	Retail investors	5%	6%	7%
	Indonesian institutional investors	29%	26%	26%
	Foreign investors	66%	68%	67%
Corporate bond market	Retail investors	1%	1%	1%
	Indonesian institutional investors	94%	95%	96%
	Foreign investors	5%	4%	3%

Note: Participation measured by percentage of stocks/corporate bonds owned in terms of market capitalization

Source: Nomura Institute of Capital Markets Research, based on IMF, *Indonesia: Financial System Stability Assessment*

18 Indonesian investors account for some 70% of daily equity trading (in value terms). Also, according to the latest figures from Bapepam-LK, there were 441,925 stock trading accounts in the names of Indonesian investors as of 30 November 2009. Overseas investors own nearly 70% of Indonesian stocks in terms of market capitalization, whereas Indonesian retail investors owned only 7% as of 2009. Indonesian retail investors own only 1% of Indonesian corporate bonds. Just as the Indonesia Stock Exchange has set itself the goal of attracting 2,000,000 domestic retail investors, Bapepam-LK has established a securities investor protection fund (SIPF) to attract more such investors and plans to require listed companies to have a minimum number of retail investors.

19 Normally it costs IDR10 million to set up an online account.

20 The turnover ratio on the secondary bond market is low and the bid-ask spread is wide.

2) Key players

There are about 120 securities companies in Indonesia. As there were more than 140 in 2004, the number of players has been declining[21]. Interviews with local market participants indicate that Indonesia's Ministry of Finance and Bapepam-LK hope to halve the number in the longer term and to improve the industry's financial soundness by imposing more onerous and stringent capital adequacy requirements.

Good examples of independent local securities companies are state-affiliated Danareksa Sekuritas and Bahana Securities, and private-sector Trimegah Securities. Meanwhile, online brokerages firms such as eTrading Securities, in which Korean Daewoo Securities has a 19.9% shareholding, and Indo Premier Securities have also increased their share of retail broking rapidly (Figure 14)[22]. US and European equity houses such as Credit Suisse and Deutsche Securities also offer brokerage services mainly for institutional clients, while local players such as Malaysia's CIMB Securities and Singapore's Kim Eng Securities and Phillip Securities have aggressively expanded their online stock brokerage businesses.

Another important group of players is securities companies affiliated to banks. The leading Indonesian banks that have fully developed their retail brokerage are Bank Mandiri and BNI. They have fully leveraged the extensive network and vast balance sheet of their parent bank to expand their retail broking business. Mandiri Sekuritas, for example, has concentrated on its wholesale business for the past few years but has been expanding its online retail business, reflecting the Mandiri Group's aim of acting as a one-stop shop for its customers as a way of stabilizing its revenue from financial services[23].

The retail securities business in Indonesia is cutthroat because of the large number of players and small number of retail investors. Brokerage commission rates in the industry as a whole have come under increasing pressure as online brokers have sought to expand their market share by cutting their rates. The commission margin for online trading is currently some 15–25bp, and the industry has been considering whether to introduce a minimum brokerage fee of 0.176% (including transaction taxes and VAT)[24].

[21] There are estimated to be 400–500 branches of securities companies in Indonesia and more than 1,600 underwriting licenses and more than 5,000 brokerage licenses.

[22] Government-affiliated securities companies have tended to win most of the mandates for IPOs of state-owned enterprises. However, this may change. Government-affiliated securities companies such as Danareksa underwrote the January 2011 IPO of Garuda Airlines, Indonesia's flag carrier. However, the IPO succeeded in raising only $510 million, about half of the expected amount—partly because the government's offering price was unrealistic and partly because of concerns about inflation.

[23] Mandiri Sekuritas has won a number of awards, including that of top Indonesian brokerage in the Asiamoney Brokers' Poll 2010 and that of best Indonesian equity house in Euromoney's 2010 Asian Awards for Excellence.

[24] The high margins of margin trading make it an important source of revenue for Indonesian securities companies.

Figure 14: Main retail brokerages in Indonesia

Company	Annual trading value (IDRbn)	Annual trading volume (million shares)	Sales ($mn)	Total capital ($mn)	Operating margin	ROE	Employees	Remarks	Head office
Danareksa Sekuritas	89,412	114,265	40	268	14.0%	2.7%	331	First broker to launch mutual fund in Indonesia	Indonesia
Trimegah Securities Tbk	52,595	107,650	20	100	20.1%	5.7%	304	Part of largest Indonesian securities company	Indonesia
Mandiri Sekuritas	44,097	72,686	N/A					Part of Bank Mandiri, Indonesia's largest bank with the largest branch network (more than 600)	Indonesia
Ciptadana Securities	54,025	111,140	N/A					"Best Securities Company 2010" (Investor Magazine)	Indonesia
Bahana Securities	39,296	30,585	N/A					Established in 1993 and named "Best Investment Bank," "Best Equity House," and "Best Broker" in 2006	Indonesia
Panin Sekuritas	22,959	48,681	39	151	75.9%	9.81%	242	Named one of "Asia's Best Companies" in 2010 (Finance Asia)	Indonesia
eTrading Securities	70,416	143,017	N/A					Indonesia's largest online broker, 19.9% owned by Daewoo Securities	Indonesia
Indo Premier Securities	60,354	140,887	N/A					Online broker	Indonesia
Kim Eng Securities[*3]	82,787	88,984	299	1,468	31.4%	10.4%	2,000	Strategic partner of Yuanta Securities of Taiwan and Mitsubishi UFJ Securities of Japan	Singapore (foreign-owned)
CIMB Securities Indonesia	82,408	90,071	3,295	74,115	35.7%	15.0%	35,922	Local subsidiary of CIMB Securities of Malaysia (financial data used on a consolidated base)	Malaysia (foreign-owned)
Credit Suisse Securities Indonesia	81,769	41,705	32,143	995,778	24.3%	18.3%	47,600	Stockbroking business in Indonesia since January 2008 (financial data used on a consolidated base)	Switzerland (foreign-owned)

Note: 1. Latest financial data.
2. USD1 = IDR9,346, SGD1.4049, MYR3.238.
3. Kim Eng Securities was acquired by Maybank, the largest financial conglomerate in Malaysia, in January 2011.

Source: Nomura Institute of Capital Markets Research

Because Indonesia is made up of more than 17,000 islands (see above), any company proposing to set up a network spanning all of them will need to invest a huge amount of money. This gives those securities companies that are affiliated to banks a competitive advantage because of their financial strength. We think that other securities companies will probably try to make online trading their mainstay business in order to compete with such rivals. However, we need to bear in mind that even securities companies looking to expand their online trading need to interview their retail clients (*Know-Your-Customer rule*) before these may open a trading account. The *KYC rule* could therefore prove to be a bottleneck[25].

[25] In an interview the Indonesia Stock Exchange told us that the securities industry was trying to persuade Bapepam-LK that the procedure for opening a trading account should be simplified on the grounds that, if applicants were bank customers, they should be regarded as having satisfied KYC requirements.

3) Mutual funds

Mutual funds are Indonesia's most popular retail investment product. In other words, retail investors' limited firepower obliges them to access the country's capital markets by means of mutual funds.

Indonesia's asset management industry began life in 1990 and, until 1995, consisted exclusively of closed-end funds. However, the *Capital Market Law 1995* permitted open-ended mutual funds. This enabled Danareksa Sekuritas to be the first local asset management company to market open-ended funds. Until 2005, bond funds were the main alternative to bank deposits. However, when interest rates rose in 2005, a bond fund managed by BNI suffered a sharp fall in price, triggering a large number of redemptions of other bond funds ("bond crash"). The reason for this was a January 2005 change by Bapepam-LK in the rules governing the valuation of bond funds. However, there was also a problem with the way in which mutual fund sales agents were allowed to market such products as it gave rise to misunderstandings among investors[26].

After the bond crash, investors tended to favor capital preservation funds because of their desire for greater security and equity funds because of tax benefits and low interest rates[27]. Exchange-traded funds have been allowed since 2006[28]. As of the end of 2010, Indonesia's mutual fund market had a net asset value of some IDR153 trillion, up by 34% from IDR114 trillion in 2009 (Figure 15), while some 320,000 investors were estimated to own units in mutual funds[29].

Opinion is divided over which types of mutual fund are likely to prove the most popular. However, discretionary funds and RDPTs (funds specializing in unlisted shares and projects) are considered two of the most likely types alongside equity funds and capital preservation funds[30]. There is also thought to be a strong potential demand for Islamic funds.

There are no official statistics in Indonesia on the distribution of mutual funds. However, it seems clear from interviews with those involved that banks are the main distributors[31]. The growth of the country's mutual fund market has been supported by

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26 The change in the method of valuing the net assets of mutual funds was from cost of acquisition to market value.

27 The Indonesian government plans to increase the rate of tax on interest income on bonds held in mutual funds registered with Bapepam-LK to 5% between 2011 and 2013 and to 15% from 2014.

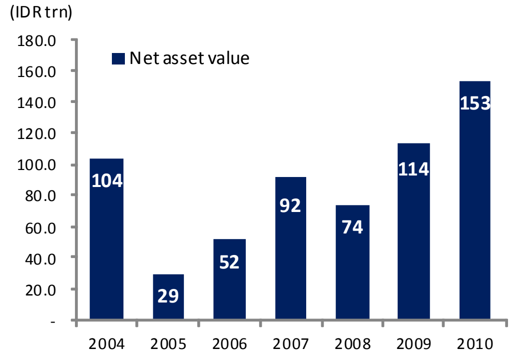
28 There were two exchange-traded funds trading in Indonesia as of the end of 2010 (Asian Bond Fund–Indonesia Bond Index Fund and Premier ETF LQ-45), and the assets held in the funds increased in value by $100 million in the course of 2010.

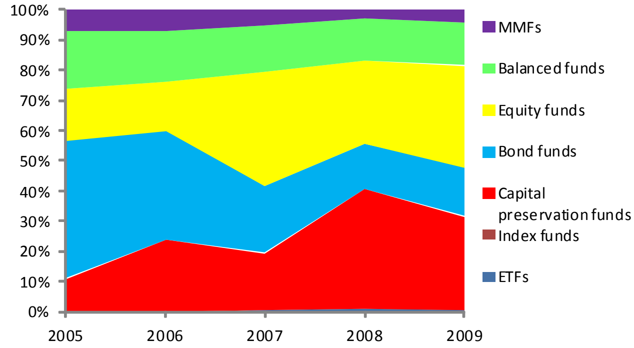
29 According to Bapepam-LK's response to an information request.

30 According to Bapepam-LK's response to an information request, the average expense ratio of Indonesian mutual funds is 1–2% a year with a sales commission of 0.5–1.0%. According to interviews with Indonesian market participants, the average expense ratio of Indonesian equity mutual funds is 2–3% a year, that of bond funds 1.0–1.5%, that of balanced funds 2%, and that of money market funds 1–1.5% with a sales commission of 0.5–2%. At the moment, Indonesia does not have any REITs.

31 Interviews with local market participants have confirmed that banks are the main distributors, accounting, in some cases, for more than 90% of a fund's distribution.

Figure 15: Mutual funds in Indonesia





Note: Data on fund types in right-hand chart through 2009.
Source: Nomura Institute of Capital Markets Research, based on Bapepam-LK data

Figure 16: Main asset management companies in Indonesia

Fund manager	Funds	NAV (IDRtrn)	Market share (%)
Schroder Investment Mgmt Indonesia (UK)	38	27.34	22.92
BNP Paribas InvestmentPartners (France)	42	16.26	13.63
Mandiri Investment Mgmt	84	15.31	12.83
Bahana TCW Investment Mgmt	57	9.06	7.59
Manulife Asset Mgmt Indonesia (Canada)	23	8.46	7.09
Batavia Prosperindo Asset Mgmt	66	4.98	4.17
Danareksa Investment Mgmt	69	4.68	3.92
Mega Capital Indonesia	14	4.06	3.4
Panin Securities	33	2.97	2.49
Trimegah Securities	14	2.93	2.46
Top 10 Total	**440**	**96.05**	**80.5**

Source: Nomura Institute of Capital Markets Research, based on Bapepam-LK, *E-monitoring Reksa Dana System* (as of 18 April 2011)

a growing number of sales agents. In 2009 the number of licensed agents increased by 2,657 to 21,152.

As far as the number of players is concerned, there were 84 asset management companies as of February 2011, with the top three in terms of net asset value (Schroders, BNP Paribas, and Mandiri) controlling roughly half of the market (Figure 16). The largest and oldest local asset manager in Indonesia is Mandiri Investment Management, part of the Bank Mandiri Group. Other leading asset management companies include Bahana TCW Investment Management, a joint venture between Bahana Securities and Los Angeles-based Trust Company of the West, Danareksa Investment Management, and Trimegah Securities[32].

The top players for each type of mutual fund are Schroders (equity funds), Danareksa (index funds), Mandiri Investment Management (capital preservation and money market funds), and Bahana TCW (bond funds), while Mandiri Investment

32 We think that companies affiliated to Indonesian banks are probably also the main players in the country's asset management market. Bank Mandiri follows an open architecture approach to the sale of mutual funds.

Management and bank-affiliated managers such as CIMB dominate the market for Islamic funds.

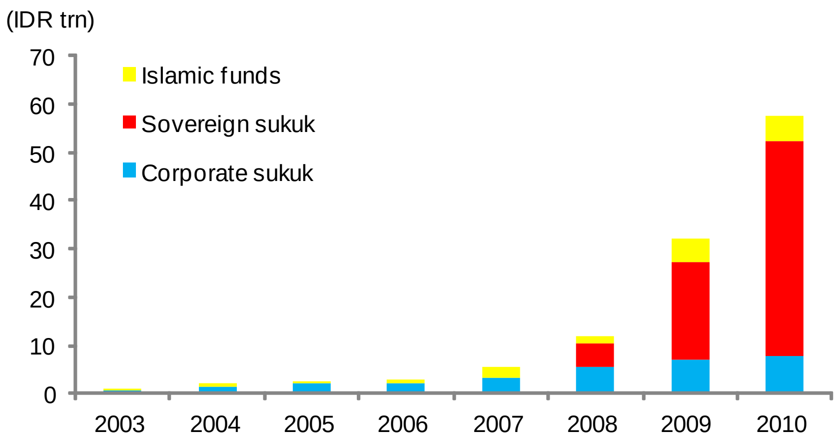
4) Islamic finance

With more than 80% (in some parts of the country 90%) of its population Moslem, Indonesia is the world's largest Islamic state. The potential for Islamic finance is therefore enormous. In 2005, in an effort to attract Middle Eastern money, which has been flowing in ever greater amounts into Malaysia, which has a well developed market for Islamic finance, the Indonesian authorities formulated a *Capital Market Master Plan*, one of whose aims is to foster the growth of Shariah-compliant financial products such as equities, bonds, asset-backed securities, and mutual funds.

Islamic finance officially began in Indonesia with the passing of *Banking Act No. 7, 1992* (following the promulgation of *Government Regulation No. 72, 1992*) and was put on a firmer legal footing when *Banking Act No. 7* was amended by *Banking Act No.10, 1998*. Since then, the country's Islamic financial market has grown rapidly, with the first Shariah-compliant investment products being officially launched in March 2003[33]. In 2009 Indonesia's first retail sovereign sukuk were issued, followed in February 2011 by three retail sovereign sukuk (SR-003) worth IDR7.34 trillion[34].

By the end of 2010 Bapepam-LK had authorized 48 Islamic funds with a total net asset value of IDR5.2 trillion (Figure 17). Furthermore, a Shariah-compliant equity benchmark (the Jakarta Islamic Index or JII) was developed in 2000. It consists of 30 Shariah-compliant stocks and had a market capitalization of IDR1,135 trillion as of 30 December 2010.

Figure 17: Net asset value of Islamic financial products



Source: Nomura Institute of Capital Markets Research, based on Bapepam-LK data

33 The Islamic Shariah Council of the National Council of Ulama Indonesia (DSN-MUI) draws up guidelines for Islamic funds and publishes a list of noncompliant investment products.

34 The first corporate sukuk were issued in 2002. By the end of 2009 43 had been issued with a combined issue value of more than IDR7 trillion. The first dollar-denominated sukuk (with a maturity of five years and a yield of 8.8%) were issued in April 2011 and were oversubscribed more than sevenfold.

However, some market participants are somewhat skeptical about the growth potential of Indonesia's Islamic financial products[35]. They point to what they see as cost disadvantages vis-à-vis conventional products as a result of the way Islamic financial products are designed and to what they see as inadequate legal provision. Yet, over the longer term we still see growth potential for the Islamic financial products. In the short run, however, we believe the success will largely depend on whether there is sufficient demand to justify the cost to providers of originating such products.

5) Related rules and regulations

According to *Ministry of Finance Decree No. 100/PMK 01/2008*, the responsibility for supervising the day-to-day activity on Indonesia's capital markets as well as for devising and implementing capital market regulations lies with Bapepam-LK[36]. In addition, Indonesia has three self-regulating organizations: the Indonesia Stock Exchange (IDX), the Indonesian Clearing and Guarantee Corporation (KPEI), and the Indonesian Central Securities Depository (KSEI). KPEI and KSEI are mainly involved in the settlement, clearing and custody of securities.

The main regulations governing Indonesia's capital markets are (1) the *Capital Market Law* (*Law No. 8 of 1995*), (2) government regulations (*No. 45 of 1995, No. 46 of 1995, and No. 12 of 2004*), (3) Ministry of Finance decrees (*No.645/No.646/No.455/No.179*), (4) Bapepam rules[37], (5) the *Financial Sector Policy Package of 2006*, and (6) the capital market master plans of 2005–2009 and 2010–2014. In particular, the *Capital Market Master Plan 2010–2014* sets out the following five objectives and strategies for the next five years in order to ensure that lessons are learnt from the financial crisis, that Indonesian financial market participants are in a stronger position, and that the necessary infrastructure (including a legal framework) is in place so that Indonesia's capital markets will be able to withstand futures crises (Figure 18).

Codes of conduct for securities companies, licensing rules, and rules governing fraud, market manipulation and insider trading are set out in the *Capital Market Law of 1995* and Chapters IV, V and XI of Bapepam's rulebook. As far as investor protection is concerned, the *Capital Market Master Plan* covers matters such as establishing a securities investor protection fund (SIPF), making it a requirement for companies to obtain the approval of shareholders for certain transactions of a highly material value, improving the role of legal consultants registered with Bapepam-LK,

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[35] The strongest growth in the demand in Indonesia for Islamic investment products has been for sovereign sukuk. There has been little growth in the demand for either corporate sukuk or Islamic funds.

[36] Bapepam-LK has 12 different functions, including that of drawing up and implementing the rules governing capital markets, supervising licensed market participants, approving accounting rules, and approving the principles governing corporate disclosure. Twelve bureaus under a chairman and a general secretary are responsible for supervising Indonesia's capital markets, pension funds, insurance industry, nonbanks and venture capital firms.

[37] There are altogether 158 rules. For further details, see http://www.bapepam.go.id/pasar_modal/regulasi_pm/peraturan_pm/indexEng.htm

Figure 18: Indonesia's *Capital Market Master Plan 2010–2014*

Objective	Strategy
An easily accessible, efficient and competitive source of funds	(1) Reducing constraints for business communities to access capital markets for funds; (2) increasing public accessibility to nonbank (e.g., venture capital) finance and guarantee institutions; and (3) improving the role of professionals, supporting institutions and underwriters in public offerings
A conducive and attractive investment climate as well as reliable risk management	(1) Increasing the distribution and quality of information disclosure; (2) encouraging diversification of capital market instruments and NBFI (nonbank financial industry) service schemes; (3) developing a Shariah capital market and Shariah nonbank financial industry; (4) encouraging the development of effective marketing channels for insurance and investment products as well as the use of the Internet; (5) developing a scheme to protect investors and customers; and (6) developing a secondary market for bonds and sukuk as well as a supervisory mechanism
A stable, resilient and liquid industry	(1) Improving the quality of market players; (2) encouraging good corporate governance practice; (3) improving risk management industry capability; (4) improving capacity to supervise industry players; and (5) improving the domestic investor base as well as provision of pensions and insurance
A fair and transparent regulatory framework which guarantees legal certainty	(1) Improving effectiveness of legal enforcement; (2) harmonizing regulation among industries and meeting international standards; (3) drafting regulations based on the needs and development of the industry; and (4) improving the transparency of financial information provided by participants in capital market and NBFI
A credible, reliable international standard infrastructure	(1) Integrating key capital markets systems (stock exchange trading system, clearing and guarantee system, and central securities depository system) and developing an efficient trading system; and (2) developing a reliable information system using technologies such as data warehousing

Source: Nomura Institute of Capital Markets Research, based on *The Capital Market and Non Bank Financial Industry Master Plan 2010–2014*

and the appropriateness of e-reporting (recognized as admissible evidence in a court of law)[38].

In its September 2010 country report on Indonesia the International Monetary Fund (IMF) recognized Bapepam-LK's work on making the regulations governing Indonesia's securities industry more transparent in order to meet the standards of the International Organization of Securities Commissions (IOSCO). However, the report also identifies shortcomings in the overall legislative framework, including the *Capital Market Law*, and the need to resolve some operational issues. It also points to deficiencies in governance and legal provision. In particular, it expresses concern that the country's financial regulators may lack the necessary legal backup to prevent political interference and undermining of the financial system.

In an effort to give Bapepam-LK more powers to detect market abuse, the Indonesian authorities have been considering setting up an Integrated Supervisory Agency. This debate began with the new law governing Bank Indonesia (1999). Some

[38] A number of systems were due to be introduced in 2011 in coordination with the self-regulatory organizations to improve investor protection: AKSES system (for identifying ownership of securities), SID system (for checking accuracy of data), and STP system (for improving liquidity).

have voiced concern that, since an Integrated Supervisory Agency would combine the regulatory functions of Bapepam-LK with those of Bank Indonesia, there could be a cultural clash between the two different organizations. The agency might not provide adequate oversight unless it is equipped with capable staff and more authority. Thus far, the authorities have been careful not to try to amalgamate these regulatory functions too hastily.

IV. Conclusion

In our view, Indonesia can offer tremendous business opportunities for retail financial services providers. Last year per capita nominal GDP broke the $3,000 barrier, and the ranks of the middle classes have been swelled as the wages of many workers (e.g., on plantations in more remote parts of the country such as Kalimantan and Sulawesi) have doubled as commodity prices have soared. The need for more efficient infrastructure remains a key issue for Indonesia if its economy is to be driven by domestic demand. Meanwhile, inflation is currently under control with the rupiah gradually appreciating against other currencies[39].

The demand for consumer loans such as auto loans, housing loans, and credit cards has grown rapidly as wages have risen and financial service providers seek to meet the needs of middle-class consumers. Indonesian banks' net interest rate margins have been eroded and they need to revamp their business portfolios as a result of the rapid growth of the country's capital markets. A move towards retail finance is therefore likely to be one of their key strategies.

The banks are at the center of Indonesia's financial system, with bank deposits accounting for more than half of personal financial assets. Although it will not be easy to induce Indonesians to transfer their money from bank deposits to investments, Indonesian pension funds have already moved some of their assets from bank deposits to investments such as equities, and the government has been encouraging individuals to make the move by offering tax incentives to mutual fund investors. Mutual funds, including Islamic funds, are still quite small in Indonesia but have been growing steadily. They are sold mainly through bank outlets.

The Indonesian government offers a range of investment courses at universities for free in an effort to encourage more people to invest—one of the goals in the *Capital Market Master Plan* unveiled this year. Though we estimate that the number of active traders is quite small (roughly 100,000–200,000), we think it could increase rapidly as the necessary infrastructure is put in place and online trading becomes more popular.

However, Indonesia does face a number of challenges if its capital markets are to grow. One is the need for individuals to have more spare cash to invest; another is the

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39 As of 11 October 2011, foreign investors were withdrawing funds from Indonesia because of the global economic slowdown, and the rupiah was depreciating. Bank Indonesia had changed its tack from that of fighting inflation to that of intervening in the foreign exchange market and cutting interest rates to stimulate economic growth.

need for investment education and for Indonesian society to become more familiar with investing in securities; and yet another is the need for investors to be protected by a legal framework. Rome was not built in a day. Therefore those involved in fostering the development of Indonesia's capital markets need to take the necessary time to work out a strategy for meeting these challenges.